



Value of strategic alliances: Evidence from the bond market



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ABSTRACT

The objective of this study is to examine the relationship between strategic alliances and the cost of debt, proxied by the at-issue yield spread of bond offerings. We hypothesize that the participation of strategic alliances lowers a firm's cost of debt because it improves the level and stability of future profit streams and reduces information asymmetry among investors. Based on 2150 bond-issuing firms during the period 1985–2009, we find evidence consistent with this argument. Furthermore, we find that the mitigating effect of strategic alliances on the debt cost is much more pronounced for firms with higher product market competition, more severe financial constraints, and greater R&D investments. Taken together, this is the first paper to examine the importance of strategic alliances in the bond market and our results highlight that corporate alliance activity is valued outside the equity market and creates additional benefits that result in lower cost of debt financing.

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“In the decades to come, businesses will either be part of an alliance or competing with one.”—Paul Lawrence, Harvard Business School

1. Introduction

Recently, inter-organizational strategic alliance activities have drawn increased interest from business and finance practitioners, as well as from academicians. Strategic alliances refer to collaborative partnerships between allying firms that pool together subsets of their own resources to achieve a common set of mutually beneficial objectives (Gulati and Singh, 1998; Baker et al., 2002). Thus, firms can access, exchange, or internalize valuable resources, both technological and financial, through strategic alliances. A recent review paper by Wassmer (2010) indicates that most of the research on alliances has focused on the emergence, management, and survival of alliances. There is little research on the effect of alliances on the cost of external capital. This paper aims to fill this gap in the literature by analyzing whether strategic alliances can reduce the cost of

debt financing. Furthermore, we examine the differential effect of alliances conditional on product market competition, financial constraints, and the technological intensity of allying firms.

With global competition and increasing uncertainty and complexity in the business environment, single firms seldom possess all the strategically critical resources required to sustain and grow their businesses. Building alliance portfolios has been seen as an effective means of dealing with these problems and achieving competitive advantages for the parties involved. In the most recent decades, strategic alliances have grown dramatically (Powell et al., 1996; Larsson et al., 1998; Ireland et al., 2002). Dyer et al. (2004), for example, reports that U.S. companies entered into 57,000 alliances from 1996 through 2001 and more than 5000 alliances were formed each year in 2002 and 2003. Indeed, anecdotal evidence suggests that nearly 6% of Fortune 1000 companies' revenues are generated from inter-organizational alliances (The Daily Deal, October 8, 2001).¹ A 1997 survey by Coopers & Lybrand also reveals that firms engaging in strategic alliances have 11% higher revenue and a 20% higher growth rate than ones without alliances.

The prevalence of corporate alliance activity, with the objective of building cooperative advantages, has motivated researchers to investigate the valuation implications of strategic alliances. Specifically, some studies have examined the impact of alliance

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¹ M. Gordon, B. Critz. “Joint Efforts.” Daily Deal (New York, NY) October 8, 2001.

announcement on the stock market valuation of allying firms. The empirical evidence on equity market value is, however, mixed. For example, Chan et al. (1997) and Anand and Khanna (2000) report that firms enjoy significant positive abnormal returns following alliance announcements, suggesting that stockholders perceive strategic alliances to be beneficial to firm value. In contrast, Das et al. (1998) find an insignificant market reaction to such announcements and imply that the benefits of strategic alliances may be offset by their costs.² In sum, whether strategic alliances really bring about (net) benefits might not be as obvious as originally thought and needs to be further investigated.

This paper takes a different view and assesses the merits of strategic alliances from the perspective of bondholders. If bondholders value corporate alliance activity, they will be willing to sacrifice a portion of their required return on firms participating in strategic alliances. The theoretical underpinnings predicting a negative association between strategic alliances and the cost of debt financing follow two related thrusts. Grounded in transaction cost theory and resource-based theory, the first is that strategic alliances enhance the level and stability of firms' future profit streams and thus lower the cost of debt. This stream of research includes work by Zahra and Bogner (1999), Vickery et al. (2003), and Lerner and Rajan (2006). Predicated on signaling theory, the second stream of research, which includes Stuart et al. (1999), Nicholson et al. (2005), and Ivanov and Lewis (2008), suggests that strategic alliances can alleviate the information asymmetry problem among investors through external alliance partners serving to signal firm value and quality.

We focus on the bond setting for several reasons. First, bondholders represent the single largest set of capital providers for most firms and bond securities make up a significant portion of a typical firm's market capitalization. In doing so, we gain new insights into how strategic alliances could indirectly affect firm value through debt financing. Second, the bond market allows for cleaner inferences when compared to the equity market. Klock et al. (2005) argue that because bonds have precise payouts and shorter durations, their prices are more accurate and less subject to the criticism that the results are driven by misspecification of the equilibrium asset pricing model than are equity prices. Third, bondholders differ from stockholders in many aspects; in particular, they are more concerned with risk, or the lower tail of the probability distribution of outcomes. As a result, our study on the importance of corporate alliance activity in the bond market adds complementary knowledge to prior research based on equity markets.

Using a sample of 2150 bond-issuing firms during the period from 1985 to 2009, we find evidence that participation in strategic alliances is associated with a lower cost of debt financing. Multiple regression analysis reveals that this negative association is robust to controlling for firm- and issue-specific characteristics, as well as macroeconomic conditions. We also find that the effect of strategic alliances on the debt cost is much more pronounced for firms with higher product market competition, tighter financial constraints, and more R&D investments because the volatility of future profit streams and value uncertainty is higher for such firms and thus the marginal benefit of strategic alliances is greater. That is,

our results suggest that strategic alliances appear to mitigate the adverse effects of inferior business environment on the cost of debt financing.

To gain further insight into the reducing effect of strategic alliances on the cost of debt, we conduct several additional analyses. First, some firms issue multiple bonds and we find that for consecutive bond issues from the same firm, our measure of the debt cost decreases across time as firms change status from not participating to participating in strategic alliances. Second, the reduction in the cost of debt is related not only to the alliance participation activity, but also to allying firms' past alliance experience. Third, the observed effect of strategic alliances appears to be due to a larger extent to technology alliances relative to marketing alliances. Fourth, we find that participation in equity-based joint ventures and participation in contractual alliances are both associated with a lower cost of debt. Fifth, the mitigating effect of strategic alliances on the cost of debt is more dramatic for small firms than for large firms. Sixth, we verify that our results are robust to various techniques used to deal with potential endogeneity concerns about corporate alliance decisions. Lastly, we find similar results when we use alternative definitions of alliance participation and when we use non-overlapping sample and mean annual regressions to prevent our results from being driven by cross-sectional dependence problems.

The closest research to ours is a recent working paper by Fang et al. (2012) that analyzes the impact of strategic alliances on private debt placements as opposed to publicly offered debt. Our work differs significantly from theirs in at least three important ways. First, the public bond investors we are interested in typically exercise limited control over the decisions of borrowers since they have limited exposure to borrowers and face free-rider problems. As a result, bondholders tend to rely more on price protection (i.e., bond yield adjustment), which, in turn, would allow us to better evaluate how debt providers value strategic alliances. Second, our analysis relies on the at-issue yield spread of bond offerings and not all-in-drawn data in the secondary market. The issuing market for corporate bonds is reportedly more liquid than the secondary market, which facilitates efficient price discovery; thus, we believe the at-issue yield spread to be a more accurate measure of a firm's cost of debt. Third, we additionally examine if debt providers' valuation of alliance activity varies with the business environment that firms face, whereas Fang et al. highlight the incremental impact of a firm's relative position in an alliance network on borrowing costs.

This study contributes to the literature in several aspects. First, our analysis suggests that bondholders exhibit interest in inter-organizational alliance activities. Second, our analysis supports the notion that strategic alliances provide a measurable and significant benefit to the firms involved, namely, through lower costs of debt financing. Thus, the consequences of firm strategic decisions are broader than a focus on equity issues alone could reveal. Our investigation of firm contextual factors as potential moderating variables is also a first step in this direction. Third, we add to the literature on alliance motives by identifying a new important incentive for engaging in strategic alliances. Fourth, our findings provide additional new evidence to suggest that participation in strategic alliances is an important way to ensure the stability of future profits and to reduce information asymmetry among market participants. To our knowledge, such evidence has not been demonstrated in prior work.

The remainder of the paper is organized as follows. Section 2 briefly reviews the theoretical motives and benefits of alliance formation and develops empirical hypotheses. Section 3 presents the data, variable measurements, and methodologies. Section 4 reports the empirical results. Section 5 provides additional analyses for robustness and Section 6 concludes the paper.

² A few studies have pointed to the non-trivial costs of strategic alliances, suggesting that alliance benefits may be offset by their costs, such as those due to the erosion of proprietary interests (Oxley and Sampson, 2004). For example, U.S. partners in cross-border alliances tend to suffer serious losses due to the involuntary loss of potential revenue and the uncompensated transfer of rent-generating resources, such as technology (Hamel et al., 1989). Moreover, contractual inefficiencies can make one firm in a strategic alliance able to opportunistically exploit its partner by exerting insufficient effort, underinvesting, or capturing a disproportionately large share of the joint payoffs created by the strategic relationship (Lerner and Malmendier, 2010). This is why some scholars argue that the net benefits of alliances have been overemphasized and find weak relations between partnerships and shareholder value (Das et al., 1998; Reuer and Koza, 2000).

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